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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1951

No. 640

BANGOR AND AROOSTOOK RAILROAD COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

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INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes, Committee Reports, and Regulations involved	3
Statement	2
Reasons for granting the writ	4
Statement in support of the petition	5
Conclusion	15
Appendix	16

CITATIONS

Cases:

Commissioner v. *Jacobson*, 336 U.S. 28	6
Commissioner v. *South Texas Lumber Co.*, 333 U.S. 496	11
Commissioner v. *Wheeler*, 324 U.S. 542	7, 11
National Grocer Co. v. *Commissioner*, 1 B.T.A. 688	12
Pillsbury v. *United Engineering Co.*, No. 229, decided January 2, 1952	9
Schwegmann Bros. v. *Calvert Distillers Corp.*, 341 U.S. 384	8
Schweppe v. *Commissioner*, 8 T.C. 1224, affirmed, 168 F. 2d 284	5
United States v. *Kirby Lumber Co.*, 284 U.S. 1	6

Statutes:

Internal Revenue Code:

Sec. 22	2, 3, 5, 7, 16
Sec. 44	11
Sec. 112	8, 10
Sec. 113	3, 9, 17
Sec. 115	6, 8, 9, 17
Sec. 118	9

Page
Sec. 711 ..... 9, 10
Sec. 718 ..... 3, 10, 19

Second Revenue Act of 1940, c. 757, 54 Stat. 974,
Sec. 115 ..... 6, 8, 9, 17

Miscellaneous:

H. Rep. 2333, 77th Cong., 2d Sess., pp. 92-93
(1942-2 Cum. Bull. 372) 9
H. Rep. 2894, 76 Cong., 3d Sess., pp. 41-43 (1940-2
Cum. Bull. 496, 526-527) 19
I.T. 3758, 1945 Cum. Bull. 159 ..... 5, 13
S. Rep. 2114, 76th Cong., 3d Sess., pp. 22-25
(1940-2 Cum. Bull. 528, 545-547) 23
Treasury Regulations 111, Sec. 29.115-3 ..... 7, 10, 11, 13, 27

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT.

Bangor and Aroostook Railroad Company, through its authorized tax counsel, files this petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the First Circuit entered in this case.

Opinions Below

The findings of fact and opinion of the Tax Court (R. 11-23) are reported in 16 T. C. 578. The opinion of the Court of Appeals (R. 37) is reported at F. 2d .

Jurisdiction

The judgment of the Court of Appeals was entered on December 31, 1951 (R. 47). The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

Question Presented

Where profit realized upon the acquisition at less than the amount owed on the petitioner's own bonds is excluded from taxable income under Section 22 (b) (9) of the Internal Revenue Code, should such profit be included in accumulated earnings and profits in computing equity invested capital for the succeeding taxable year?

Statutes, Committee Reports, and Regulations Involved

The basic statutes involved are sections 718 (a) (4), 22 (b) (9), and 115 (l) of the Internal Revenue Code. Other statutes involved together with pertinent committee reports and regulations are referred to and quoted from in the Appendix, *infra*, pp. 16-29.

Statement

The facts as agreed to by the parties and found by the Tax Court (R. 12-14) are as follows:

Petitioner is a corporation organized under the laws of the State of Maine, and has its principal office at Bangor, Maine. It filed its excess profits tax return for the calendar year 1943 with the Collector of Internal Revenue for the District of Maine. Petitioner kept its books and prepared its income and excess profits tax returns on the accrual basis.

During the calendar year 1942, petitioner purchased in the open market certain of its bonds for retirement and cancellation. The aggregate par value of these bonds was $634,000, and the total price paid for them by petitioner was $497,553.30. The difference amounted to $136,446.70, and is hereinafter referred to as the "bond profit." This profit was recorded in the profit and loss accounts of the petitioner's books, which were maintained in accordance with the system of accounts prescribed by the Interstate Commerce Commission.

In its income tax return for 1942, no portion of that profit was included in the computation of petitioner's net income, normal tax net income or surtax net income. Neither was any part of the bond profit included in the excess profit net income petitioner reported for 1942. Together with its income and declared value excess profits tax returns for 1942, petitioner filed a Treasury Department form in which it stated that it had excluded the bond profit from its gross income pursuant to Section 22 (b) (9) of the Internal Revenue Code, and consented to have the basis of its property adjusted in accordance with respondent's regulations under Section 113 (b) (3) of the Internal Revenue Code. But petitioner did not reduce the basis of any property either on its books or in its income or declared value excess profits tax returns. In its income tax return for 1942, petitioner claimed deductions for depreciation, cost of property retired and replaced, losses on retirements, and losses on equipment destroyed, all computed on the unreduced basis of the property involved.

Petitioner elected to compute its excess profits credit for 1943 on the invested capital method. In calculating the credit, petitioner was entitled to include, in its equity invested capital, under Section 718 (a) (4) of the Internal Revenue Code, its "accumulated earnings and profits" as of the beginning of the taxable year. Petitioner included in those earnings and profits the bond profit of $136,446.70.

In connection with petitioner's 1942 income tax, respondent reduced the basis of petitioner's depreciable property pursuant to Section 113 (b) (3) of the Internal Revenue Code and the consent filed by the petitioner. The reduction in basis required a reduction of $1,736.69 in the amounts of the deductions taken by the petitioner in 1942 for depreciation, property retired and replaced, and losses on retirements and on equipment destroyed. Respondent also disallowed, under Section 22 (b) (9) of the Internal Revenue

Code, a deduction of $1,659.63 taken by the petitioner for unamortized discount on some of the bonds purchased by it. The total thus disallowed, as income tax deductions for 1942, was $3,396.32. The petitioner has conceded that disallowance in this amount was correct.

This amount of $3,396.32, not allowed as a deduction in computing petitioner's 1942 net income, was added by the respondent to petitioner's accumulated earnings and profits as of the beginning of 1943. At the same time such earnings and profits were decreased by the respondent in the amount of the bond profit of $136,446.70. The respondent therefore decreased the accumulated earnings and profits by the net amount of $133,050.38. On the basis of the resulting reduction in the excess profits credit, the respondent asserted a deficiency in petitioner's excess profits tax for 1943.

The Tax Court agreed with the Commissioner and the Court of Appeals affirmed (R. 37).

Reasons for Granting the Writ

1. The Court of Appeals has decided an important question of federal tax law which has not been, but should be, settled by this Court.

2. The Court of Appeals has decided a question important in many federal tax controversies in a way in conflict with applicable decisions of this Court and at variance with principles enunciated therein.

3. The Court of Appeals, in extending the expressly limited scope of pertinent legislation in one instance and in refusing to permit the express language of the Internal Revenue Code to be given its ordinary meaning in another, has so far departed from the accepted and usual course of judicial proceedings, and has so far sanctioned such a departure by the Tax Court, as to call for an exercise of this Court's power of supervision.

Statement in Support of the Petition

The sole question of law in this case is whether gain derived through the acquisition of its own bonds at a saving, in open market transactions, constitutes a proper part of the taxpayer's earnings and profits. The question in this instance relates to the computation of equity invested capital for excess profits tax purposes, but the decision in this case will likewise govern the taxability of corporate dividends in instances where there would be an absence of earnings and profits except for the inclusion of such bond profits. In dividend cases, involving comparable situations, the Government has generally taken a position basically inconsistent with that here asserted and has been sustained by the courts.[1]

While the dollar amount at issue in this case is small, since only those acquisitions in the first year after the enactment of the present Section 22 (b) (9) of the Internal Revenue Code are here involved, the cumulative effect for this taxpayer is substantial in later years. In addition, millions of dollars are involved in the many other cases where the years 1942-1946 are still in controversy. For example, Southern Railway Company, which appeared through counsel as *amicus curiae* in this case in the Court of Appeals, now faces asserted federal tax deficiencies in excess of one million dollars as a result of the decision in that Court. In

[1] See in this connection, *Schweppe* v. *Commissioner*, 8 T.C. 1224, affirmed, 168 F. 2d 284 (C.A. 9th), where it was ruled that the release of assets and the enhancement of net worth as a result of the elimination of an indebtedness served to increase "earnings and profits" even though the amount involved was not taxed as income. In that case the company took the position that the release of the indebtedness in question was a contribution to capital. The court concluded that the indebtedness was cancelled by the statute of limitations in an earlier year which was then barred. The effect of such a cancellation was to increase "earnings and profits" and accordingly the distributions to stockholders in the years before the court were held to be taxable as dividends. See also I.T. 3758, 1945 Cum. Bull. 159.

the related cases involving the taxability of dividends for past, present and future years, where the Government would lose as a result of this decision, the amounts will undoubtedly be very substantial. Moreover, under the excess profits tax law in effect for 1950 and later years, the decision will have a direct bearing upon those corporations which use the historical method of computing invested capital. The question is therefore one of general and continuing importance. Since Congress has never fully defined earnings and profits, further consideration of this problem by this Court would aid the administration of the tax laws.

It has been generally assumed that the question whether gain is to be included in earnings and profits for tax purposes turns primarily upon the twofold inquiry, to wit, whether it was realized in a definitive transaction and recognized as such. In the absence of applicable restrictive legislation, the economic realities should govern the computation of earnings and profits.[2] The Government has not questioned the reality of the gain here. The business transactions from which this bond profit was derived were final and represented definitive changes both from a business point of view and a tax point of view. In *Commissioner* v. *Jacobson,* 336 U. S. 28, this Court spoke of such a taxpayer as having (p. 38) "realized an immediate financial gain." There, and in the earlier case *United States* v. *Kirby Lumber Co.,* 284 U. S. 1, this Court regarded such bond profit as income includible under the broad provisions of Section 22 (a) of the Internal Revenue Code.

The Government's position, as upheld by the courts below, is that the bond profit was not "recognized" as income. It is not enough to say that the bond profit was not taken into

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[2] In the concluding paragraph of the Committee Report (Appendix, *infra*), explaining the scope of Section 115 (l), it was stated that, except as therein limited, earnings and profits were to be computed "conformably to the best accounting practice."

account in computing the current year's income tax and was therefore not "recognized." Many adjustments to taxable income, both debits and credits, are required annually in Schedule M of the Treasury Department's corporate tax form 1120 in order to arrive at the true earnings and profits. Some of these adjustments are expressly covered in Treasury Regulations 111, Section 29.115-3 (Appendix, *infra*). See also *Commissioner* v. *Wheeler,* 324 U. S. 542, at 546, where this Court observed that the concept of earnings and profits does not "correspond exactly to taxable income." The best demonstration of why earnings and profits are not and cannot be the same as the sum of taxable income through the years is the fact that federal income taxes are not deductible in computing taxable income but must be deducted in any reasonable computation of earnings and profits.

And yet the courts below have applied the theory that the bond profit cannot be considered an earning and profit in 1942 for the reason that it was not taken into account in computing 1942 income tax. The Tax Court concluded (R. 22) that in Section 22 (b) (9) Congress "deferred recognition of the profit and collection of the tax" and that recognition for earnings and profits purposes was deferred until (R. 22) "the time that the gains * * * are actually taken into account in computing taxable income." It seems obvious that, by including the bond profit in the same subsection with true exemptions from tax, Congress fully recognized the existence of the gain and merely deferred collection of the tax. This should be clear from the decision of this Court in the *Jacobson* case, *supra,* where the observation was made that immediate financial gain was necessarily recognized, otherwise (p. 42) "there was no need for" the enactment of Section 22 (b) (9). Furthermore, this Court pointed out in the *Jacobson* case (p. 44) that "those gains are not excluded from gross income for all purposes," observing that under Section (22) (b) (9) the exclusion is only from taxa-

tion imposed by the income tax chapter of the Code. The courts below refused to follow this decision, but, on the contrary, held that the bond profit is to be excluded, in the sense of being non-recognized, for all purposes. This failure properly to interpret this Court's decision calls for review by this Court.

It seems clear that this "immediate financial gain" should be reflected in earnings and profits unless excluded by some legislative action. In Section 115 (l) Congress expressly provided that certain transactions, primarily non-taxable exchanges under Section 112, should have no bearing upon earnings and profits until the disposition has become more definitive, but in that statute and more particularly in the Committee Reports (Appendix, *infra*) Congress made it clear that it was dealing only with specified situations. The Tax Court frankly stated (R. 18) that Section 115 (l) does not cover this case, but proceeded to assume (R. 18) "an expression of legislative intent" from its enactment which it accepted as "guidance." This approach is at variance with that adopted by this Court in *Schwegmann Bros.* v. *Calvert Distillers Corp.*, 341 U. S. 384, where it refused (p. 388) "to perform a distinct legislative function by reading into the Act a provision that was meticulously omitted from it."

The court below took the view that the bond profit exemption from tax, "as a matter of artistic draftsmanship, is perhaps misplaced" when placed by Congress in Section 22 (b) and proceeded to treat the case as if subsection 22 (b) (9) had been made a part of Section 112, the basic non-recognition statute. It so happens that in 1942, when the presently enlarged Section 22 (b) (9) was first enacted, Congress amended Section 112 (f), dealing with involuntary conversions, which had only recently been added to the category of transactions where gain was not to be "recognized." The treatment of bond profits in

Section 22 (b), rather than in Section 112, cannot be assumed to be a reflection on the legislative draftsmanship. Congress was well aware of the difference between the two categories. In *Pillsbury* v. *United Engineering Co.*, No. 229, decided January 2, 1952, this Court pertinently observed that "Congress knew the difference between 'disability' and 'injury' and used the words advisedly" and accordingly refused "to rewrite the statute." The failure of the courts below to apply these elementary principles of statutory construction so far departs from the accepted and usual course of judicial proceedings as to call for exercise of this Court's power of supervision. If this Court will not rewrite the statute, it should not permit the courts below to do so.

Even a cursory examination of the legislative background here will show that the failure to cover this situation in the non-recognition provisions of Section 115 (l) was no oversight. This section was enacted as a part of the Second Revenue Act of 1940. In 1942, the same year in which Section 22 (b) (9) was enlarged to provide for the conditional exclusion or deferment of the tax on bond profits, Congress reconsidered Section 115 (l) and amended it to include in its coverage wash sales. Although a loss on a wash sale was disallowed for income tax purposes under Section 118 and under Section 113 (a) (10) the basis of the stock (for purposes of future disposition) was changed to reflect the disallowance, Congress deemed it necessary to enact special legislation to cover the surplus adjustment and so stated in the Committee Reports. See Ways and Means Committee Report, H. R. 2333, 77th Congress, 2d Session, pp. 92-93.

Moreover, under Section 711 (a) (2) (E), the then current provision of the Code dealing with taxpayers computing the excess profits credit under the invested capital method, "income derived" from the acquisition of the company's own bonds was expressly excluded from income

subject to excess profits tax (irrespective of an election under Section 22(b)(9) for income tax purposes). Although under Section 711(a)(2) bond profits and a number of other items such as capital gains and bad debt recoveries were excluded from excess profits net income, no provision was made by Congress for any adjustment, through surplus or otherwise, in computing the invested capital. To the contrary, in Section 718(a) equity invested capital was specified as the full amount of money and the "unadjusted" basis of property paid in to the company for stock plus "accumulated earnings and profits," with no adjustment required with respect to the above-mentioned exclusions. By contrast, in the related subsection dealing with taxpayers computing the excess profits credit under the income method, Section 711(b)(1)(C), such bond profit was excluded from the base period income. The only possible conclusion is that, if Congress had intended to exclude bond profits from earnings and profits, it would have so provided in Section 112, in Section 115 (l), in Section 711(a), or in Section 718(a), all of which were under consideration by Congress at about the same time.

The courts below have unduly extended specific legislation to a situation admittedly not covered by statute and quite obviously not intended by Congress to be covered and review by this Court is called for. In view of the rulings of this Court that such bond profits constitute income within the meaning of Section 22(a) of the Code, and in view of the specific provisions of Section 29.115-3 of Regulations 111 (Appendix, *infra*) to the effect that earnings and profits embrace "all items includible in gross income under Section 22(a)," such bond profits logically fall within the concept of earnings and profits unless excluded by some statute. Neither the government nor either of the courts below has ever asserted there is any such statute.

In referring to principles enunciated by this Court in *Commissioner* v. *Wheeler*, 324 U. S. 542, and in *Commissioner* v. *South Texas Lumber Co.*, 333 U. S. 496, as involving analogous situations, the courts below have misinterpreted the decisions of this Court. The *Wheeler* case dealt with a Section 112 (b) non-taxable exchange which had long been regarded by Congress as an economic change (p. 546) "not definitive enough to be given tax consequences." For that reason the exchange was not recognized for tax purposes. Treasury Regulations expressly provided that such exchanges should have no effect upon earnings and profits. It was this treatment which Congress expressly approved in Section 115 (l), but, by doing so, Congress made it clear that it was covering only this and similar specified situations. By contrast, the acquisition of its bonds in open market transactions by the taxpayer here, was as final and definitive a business transaction as could be. No "paper" exchange was involved as in the case of a Section 112 (b) transaction. Section 22 (b) (9) is in no way comparable with Section 112 (b). As previously indicated, Section 22 (b) (9) necessarily recognized the reality of the gain and merely provided for a conditional exemption or deferment of the tax.

The Court below also misinterpreted the decision of this Court in the *South Texas Lumber Company* case, *supra*. Under the installment statute, Section 44 of the Internal Revenue Code, the right to use the installment method of accounting is expressly made subject to Treasury Regulations which require that the same installment method of accounting be used in computing earnings and profits. Section 29.115-3 of Regulations 111 (Appendix, *infra*). In electing to use the installment method of accounting, the taxpayer necessarily consents to such Regulations. Moreover, this installment situation was specifically incorpo-

rated in the "nonrecognition" provisions of Section 112 by express reference thereto in Section 112 (j) of the Code. In contrast, no change in the method of accounting is involved in the bond profit situation. The gain is reflected on the books of the company for all purposes. No statute and no regulation call for any adjustment. The conditions upon which exemption of such gain from current income tax was granted were specifically made applicable only in computing income tax to be currently paid. Moreover, as pointed out by this Court in the *South Texas* opinion, the courts and the Board of Tax Appeals had specifically held under the comparable World War I excess profits tax law that profits on deferred installments could not be included in invested capital. Again by contrast, the Board of Tax Appeals had held in a statutory situation on all fours with ours (*National Grocer Co.* v. *Commissioner*, 1 B. T. A. 688 (acq. IV-1 Cum. Bull. 3)) that the profits in question do form a proper part of invested capital despite the fact that they were excluded from income tax upon the condition that a reduction of basis be accepted.

Finally, the court below sought to bolster the erroneous conclusion reached in this case by assuming that otherwise, under Section 115 (l), there would be a double adjustment of earnings and profits (R. 23). In so doing the following exception in Section 115 (l) was disregarded:

> Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided.

Under this statutory exception, and consistent with its position that the reality of the bond profit should be recognized in the first instance, this taxpayer agrees that in

future years the adjustment of earnings and profits should likewise be based upon the realities of the situation and should not be affected by the adjustment of basis for income tax computation purposes. The same assets will continue to depreciate at the same rate and the taxpayer's books will reflect the true depreciation. Only in computing income tax will the depreciation be reduced by the application of a composite percentage factor to reflect the Section 113(b)(3) adjustment. Earnings and profits will continue to be charged with the actual depreciation sustained. This, we submit, was contemplated in the above exception in Section 115(l). Moreover, it would seem to be called for by the Commissioner's own Regulation, Section 29.115-3 of Regulations 111 (Appendix, *infra*), where a different adjustment is required in computing earnings and profits in the analogous situation of depreciation based upon March 1, 1913, value rather than cost and of the use of percentage depletion rather than cost depletion in computing the income tax.[3]

As stated, the Commisioner's own tax forms contemplate adjustments of this type. For example, in Schedule M of Treasury Department Form 1120, numerous adjustments of earnings and profits are called for. The general outline of the form contemplates taking the earnings and profits as of the beginning of the tax year as a start. To that figure is

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[3] See also I.T. 3758, 1945 Cum. Bull. 159, where, after reviewing Section 115(l), the conclusion was announced that adjustment of the basis for determining gain or loss for income tax purposes, as where the basis of stock of affiliated companies is reduced by operating losses availed of in consolidated returns, "is not an adjustment proper in computing earnings and profits for the purpose of determining taxability of dividend income and for the purpose of determining the amount to be included in the computation of equity invested capital." That ruling significantly pointed out (p. 160) that "the computation of earnings and profits of a corporation for dividend purposes is based upon reasonable accounting concepts" and concluded that exclusions or adjustments of basis for income tax computation purposes were not controlling.

added not only the taxable income shown on the face of the return for the current year but also items of non-taxable income. Along with such items as exempt interest would appear the bond profits here in question. In a parallel column of Schedule M contra adjustments are called for, representing proper charges against earnings and profits which are not reflected in taxable income as stated on the return. Along with charges such as dividends paid would go the difference between actual depreciation sustained and the depreciation deducted for income tax purposes, the item here under discussion. This particular compensating adjustment of earnings and profits is, we submit, called for under Item 13 of Schedule M, entitled "Adjustments for tax purposes not recorded on books." In applying this analysis of earnings and profits on the Commissioner's own form, this taxpayer annually makes the proper adjustment or compensating reduction of earnings and profits covering the very item here in question. It is thus apparent that under the taxpayer's theory and under a proper analysis of the pertinent statute and regulation, there will be no double adjustment of earnings and profits.

On the other hand, the taxpayer will be doubly penalized if this decision is allowed to stand. By redeeming these bonds in 1942, it lost the benefits of the full amount thereof as borrowed capital in computing its invested capital credit during the high excess profits tax years. While this was a calculated burden, the taxpayer did not contemplate that it would also lose the right to include in earnings and profits the gain realized by acquiring the bonds at a discount. That additional tax burden could not have been reasonably contemplated, for Congress had carefully refrained from imposing any such requirement. In this connection, it is essential to remember that Section 22 (b) (9) was a relief provision, peculiarly applicable to railroads, intended to

make it possible for the railroads to reduce outstanding debt. Such remedial legislation should not be thwarted by judicial action attaching a burden not contemplated by Congress. It was thus thwarted by the courts below.

Conclusion

This petition for a writ of certiorari should be granted.

Respectfully submitted,

JOSEPH M. JONES,
Counsel for Petitioner.

March 1952.

APPENDIX

STATUTES INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

* * * * * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * * * *

(9) *Income from Discharge of Indebtedness.*—In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer or for which the taxpayer is liable evidenced by a security (as hereinafter in this paragraph defined) if the taxpayer makes and files at the time of filing the return in such manner as the Commissioner, with the approval of the Secretary, by regulations prescribes, its consent to the regulations prescribed under section 113 (b) (3) then in effect. In such case the amount of any income of the taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction. As used in this paragraph the term "security" means any bond, debenture, note, or certificate, or other evidence of indebtedness, issued by any corporation. This paragraph shall not apply to any discharge occurring before the date of enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, 1945.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * * * *

(3) *Discharge of Indebtedness.*—Where in the case of a corporation any amount is excluded from gross income under section 22 (b) (9) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 22 (b) (9) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Commissioner with the approval of the Secretary) in effect at the time of the filing of the consent by the taxpayer referred to in section 22 (b) (9). The reduction shall be made as of the first day of the taxable year in which the discharge occurred except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began.

* * * * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(1) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain

or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such realized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. For the purposes of this subsection, a loss with respect to which a deduction is disallowed under section 118, or a corresponding provision of a prior income-tax law, shall not be deemed to be recognized. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

SEC. 718. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * * * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year.

PERTINENT COMMITTEE REPORTS

H. Rep. No. 2894, 76th Cong., 3rd Sess., pp. 41-43 (1940-2 Cum. Bull. 526-527):

SECTION 401. EARNINGS AND PROFITS OF CORPORATIONS.

The purpose of this amendment is to clarify the law with respect to what constitutes earnings and profits of a corporation. This is important not only for the purpose of determining whether distributions are taxable dividends but also in determining equity invested capital for excess-profits-tax purposes.

Section 401 of the bill inserts subsection (l) in section 115 of the Internal Revenue Code and correspondingly amends prior revenue acts. The rule, applied by the Treasury under existing law, is that while gains or losses which are not recognized by reason of the provisions of section 112 neither increase nor diminish the

earnings or profits, the earnings or profits are increased or diminished by the entire amount of the recognized gain or loss, computed in accordance with the provisions of sections 111, 112, and 113. Together with the provisions of section 115 (h) of the Internal Revenue Code, and the principles established in *Commissioner* v. *Sansome,* 60 F. (2d) 931, and following decisions, the rule effectuates the provisions of section 112. While taxpayers generally have concurred in the rule applied by the Treasury, the Board of Tax Appeals and some of the courts have not agreed but have followed the theory that gain or loss, even though not recognized in computing net income, nevertheless affects earnings and profits. For example, on January 1, 1930, the X corporation owned stock in the Y corporation which it had acquired in 1929 in a transaction wherein no gain or loss was recognized. The adjusted basis to the X corporation of the property exchanged by it for the stock in the Y corporation was $100. The fair market value of the stock in the Y corporation received by the X corporation was $1,000. On April 9, 1930, the X corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1929, had no accumulated earnings or profits as of that date. Under the interpretation of the Board and some of the courts, the excess of the fair market value of the stock of the Y corporation over the basis, $900, would represent earnings or profits, and the cash distribution would be a taxable dividend (*Commissioner* v. *F. J. Young Corporation,* 103 F. (2d) 137). Under the proposed legislation and Treasury practice, the $900 would not represent earnings or profits, and the cash distribution would not be a taxable dividend. The need for certainty, not only with respect to the determination of when dividends are taxable but also in the computation of the excess profits tax credit, makes it desirable to clarify existing law.

Provision is made for cases in which the adjustment to the basis prescribed by section 113 is different from the adjustment to such basis proper for the purpose of

determining earnings or profits. Thus, section 113 (b) (1) (B) requires adjustment for depletion, to the extent allowed (but not less than the amount allowable). Since the only depletion deductions to be considered in the computation of earnings or profits are those based on (1) the cost or other basis prescribed by section 113, if the depletable asset was acquired subsequent to February 28, 1913, or (2) the basis prescribed by section 113, or March 1, 1913, value, whichever is higher, if the depletable asset was acquired prior to March 1, 1913, the adjustment to the basis in such a case is of such depletion deductions, and not "depletion, to the extent allowed (but not less than the amount allowable)".

Certain tax-free distributions when received have uniformly been treated by the Treasury as not increasing the earnings or profits of the distributee for the period after February 28, 1913, of the distributee. Thus, distributions out of earnings or profits accumulated prior to March 1, 1913, or out of increase in value of property accrued prior to March 1, 1913, or otherwise than out of earnings or profits accumulated since 1913 or the earnings or profits of the taxable year, have, to the extent to which they do not exceed the adjusted basis of the stock in respect of which the distribution was made, been applied in reduction of the basis of such stock, with the result that earnings or profits are increased, upon the sale of such stock, by the entire amount of the recognized gain computed upon the basis so reduced. Tax-free distributions in stock or in rights, whether not constituting income within the meaning of the sixteenth amendment or exempt to the distributee under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior revenue act, and tax-free distributions of stock or securities in a corporation a party to a reorganization, have consistently been treated by the Treasury as not resulting upon receipt in an increase in earnings or profits, but as causing the basis of the stock in respect of which the distribution was made to be allocated

between such stock and the stock securities received, with the result that earnings or profits are increased, upon the sale of such stock or property, by the entire amount of the recognized gain computed upon the basis so determined by allocation. In order that the confusion which occasioned the enactment of section 214 (a) of the Revenue Act of 1939, may not reappear in the computation of earnings or profits, section 401 explicitly states the rules heretofore applied by the Treasury.

It should be noted that the provisions of section 401 are applicable only in determining the earnings or profits for periods beginning after February 28, 1913. In the case of a corporation organized before March 1, 1913, its entire accumulated earning or profits as of any date after February 28, 1913, consists of its earnings or profits accumulated after February 28, 1913, its earnings or profits accumulated prior to March 1, 1913, and its increase in value of property accrued prior to March 1, 1913, which has been after February 28, 1913, realized by a sale, or has otherwise been brought into account in computing its earnings or profits accumulated after February 28, 1913. With respect to earnings or profits accumulated after February 28, 1913, section 401 does not purport to prescribe rules for anything other than certain exceptional cases, namely, the nonrecognition provisions of section 112, use of value as of March 1, 1913, as the basis for determining gain or loss, and depreciation and depletion, and tax-free distributions which either are applied in reduction of the basis or cause the basis to be allocated.

While prescribing rules for certain cases (which apply not only in determining earnings or profits for periods beginning after February 28, 1913, but also, to the extent to which such earnings are a factor, in determining the entire accumulated earnings or profits of a corporation), section 401 contemplates that consistently with these rules the computation shall be made conformably to the best accounting practice.

S. Rep. No. 2114, 76th Cong., 3rd Sess., pp. 22-25 (1940-2 Cum. Bull. 545-547):

SECTION 501. EARNINGS AND PROFITS OF CORPORATIONS

The committee amendment rearranges section 401 of the House bill but otherwise makes no substantial change. Three new subsections are added to section 115 of the Internal Revenue Code relating to distributions by corporations. Subsection (l) defines earnings and profits of a corporation as the sum of (1) its earnings and profits accumulated after February 28, 1913, (2) its earnings and profits accumulated before March 1, 1913, plus (3) the increase (to the extent provided in subsection (n)) in value of its property accrued before March 1, 1913, but realized on or after such date.

Subsection (m) prescribes rules for the computation of earnings and profits accumulated after February 28, 1913, and earnings and profits of the taxable year or other period after February 28, 1913. It deals with the following matters:

1. The basis upon which gain or loss, for the purposes of determining such earnings and profits, is to be computed.
2. The adjustments to be made to such basis in such computation.
3. The effect upon such earnings and profits of the application of the nonrecognition provisions of law to the gain or loss so computed.
4. The effect upon such earnings and profits of distributions from another corporation if such distributions actually reduce the basis of the stock in respect of which the distribution is made, or cause such basis to be allocated.

The subsection provides that the gain or loss realized from the sale or other disposition (after February 28, 1913) of property shall, for the purpose of computing the earnings and profits (for any period

beginning after February 28, 1913), be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain. For example, stock in the X corporation was acquired by the Y corporation prior to March 1, 1913, at a cost of $90, its March 1, 1913, value was $120, and in 1939 it was sold for $100. The basis (under the law applicable to the year 1939) for determining gain is the cost or March 1, 1913, value, whichever is higher. As the Y corporation received $100 for the stock of the X corporation, and its value on March 1, 1913, $120, exceeded its cost, $90 (assuming that there are no adjustments to be made to the basis), the Y corporation realized a loss under the provisions of this subsection of $20. If such a loss is recognized under section 112, the decrease in the earnings and profits accumulated by the Y corporation after February 28, 1913, as the result of this transaction in 1939 was $20 notwithstanding provisions of the code to the effect that no deduction was allowable in computing net income.

The subsection also provides that the realized gain or loss shall increase or decrease the earnings and profits (for any period beginning after February 28, 1913) to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. This provision relates to gains or losses which are recognized, pursuant to the provisions of law, for instance, by reason of the provisions of section 112 of the Internal Revenue Code. It does not relate to losses disallowed or not taken into account such as those under section 24 (b), section 118 and section 117 of the code. For example, on January 1, 1939, the X corporation owned stock in the Y corporation which it had acquired in 1938 in an exchange transaction in which no gain or loss was recognized. The adjusted basis to the X corporation of the property exchanged by it for the stock in the Y corporation was $100. The fair market value of the stock in the Y corporation when received by the X

corporation was $1000. On April 9, 1939, the X corporation declared a cash dividend of $900 and, except for the possible effect of the transaction in 1938, had no accumulated earnings or profits. The excess of the fair market value of the stock of the Y corporation over the basis, $900, was not recognized gain under the provisions of section 112 of the Revenue Act of 1938. Accordingly, its earnings and profits are not increased by $900 and the distribution was not out of earnings and profits.

The subsection applies regardless of the form taken by the sale or other disposition resulting in the accumulation of earnings and profits. For example, suppose that oil property which X had acquired in 1922 at a cost of $28,000 was transferred to a corporation in 1924 in exchange for all of its capital stock; that the fair market value of the stock and of the property as of the date of the transfer was $247,000; and that the corporation after 3 years' operations, effected in 1927 a cash distribution to X in the amount of $165,000. In determining the extent to which the earnings and profits of the corporation available for dividend distributions have been increased as the result of production and sale of oil, it is intended that depletion should be taken into account computed upon the basis of $28,000 established in the nontaxable exchange in 1924 regardless of the fair market value of the property or the stock issued in exchange therefor.

The subsection further provides that where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution is made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits (for any period beginning after February 28, 1913) of the first corporation in certain cases of tax-free distributions. For example, if in the illustration in the second preceding paragraph the cash dividend of $900 was received by the Z corporation, the sole stockholder of the X corporation, it would be applied (if the adjusted basis of the

stock is not in excess of $900) in reduction of the stock in respect of which the distribution was made and would not increase the earnings and profits of the Z corporation.

Provision is also made for cases in which the adjustment of the basis prescribed by section 113 is different from the adjustment to such basis proper for the purpose of determining earnings or profits. The effect of such provision may be illustrated by the following example: The X corporation purchased on January 1, 1931, an oil lease at a cost of $10,000. The lease was operated only for the years 1931 and 1932. The deduction allowed for depletion in each of the years 1931 and 1932 amounted to $2,750, of which amount $1,750 represented percentage depletion in excess of depletion based on cost. The lease was sold in 1940 for $15,000. Section 113 (b) (1) (B) of the Internal Revenue Code provides that in determining the gain or loss from the sale of the property the basis must be adjusted for cost depletion of $1,000 in 1931 and percentage depletion of $2,750 in 1932. However, the adjustment of such basis, proper for the determination of earnings and profits, is $1,000 for each year, or $2,000. Hence, the cost will be adjusted only to the extent of $2,000, leaving an adjusted basis of $8,000 and the earnings and profits would be increased by the realized gain of $7,000 and not by the taxable gain of $8,750, the difference having previously been taken into account in computing earnings and profits.

If in the preceding example the property, instead of being sold, was exchanged in a transaction described in section 112 (b) or (c) for other like property having a value of $7,750 and cash of $7,250, then the gain for earnings and profits purposes amounts to $7,000, that is $15,000 ($7,750 plus $7,250) minus the base of $8,000. However, for net income purposes the gain is $8,750, that is $15,000 minus ($10,000 less depletion of $3,750) of which only $7,250 is recognized for net income purposes because such gain cannot exceed the sum of money received in the transaction. Section 112 (c) (1), Internal Revenue Code and corresponding provisions

of prior revenue laws. If, however, the cash received was only $2,250 and the value of the property received was $12,750, then the gain for earnings and profits purposes would be $2,250, that amount being the gain recognized under section 112.

Of course, mere increase or decrease in value (after February 28, 1913) of property while owned by a corporation does not increase its earnings and profits.

Under various provisions of the Internal Revenue Code dealing with exchanges and liquidations, the transfer of the property by a corporation to another corporation results in the nonrecognition, in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. These principles are to be given full effect under section 501. The requirement of section 501 that there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee.

PERTINENT REGULATIONS

Treasury Regulations 111:

Sec. 29.115-3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be conclusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance, a corporation keeping its books and filing its income tax returns under sections 41, 42 and 43 on the cash receipts and disbursements basis may not use the

accrual basis in determining earnings and profits; corporation computing income on the installment bas as provided in section 44 shall, with respect to the i stallment transactions, compute earnings and profi on such basis; and an insurance company subject taxation under section 204 shall exclude from earnin and profits that portion of any premium which is u earned under the provisions of section 204 (b) (5) a which is segregated accordingly in the unearned pr mium reserve.

Among the items entering into the computation corporate earnings or profits for a particular perio are all income exempted by statute, income not taxabl by the Federal Government under the Constitution, a well as all items includible in gross income under se tion 22 (a) or corresponding provisions of prior Rev nue Acts. Gains and losses within the purview or se tion 112 or corresponding provisions of prior Revenu Acts are brought into the earnings and profits at th time and to the extent such gains and losses are recog nized under that section (see section 29.115-12). Inte est on State bonds and certain other obligations although not taxable when received by a corporatio is taxable to the same extent as other dividends whe distributed to shareholders in the form of dividend

In the case of a corporation in which depletion o depreciation is a factor in the determination of income the only depletion or depreciation deductions to b considered in the computation of the total earning and profits are those based on cost or other basis with out regard to March 1, 1913, value. In computing th earnings and profits for any period beginning afte February 28, 1913, the only depletion or depreciatio deductions to be considered are those based on (1) cos or other basis, if the depletable or depreciable asse was acquired subsequent to February 28, 1913, or (2 adjusted cost or March 1, 1913, value, whichever i higher, if acquired prior to March 1, 1913. Thus, dis covery or percentage depletion under all Revenue Act for mines and oil and gas wells is not to be taken int

consideration in computing the earnings and profits of a corporation. Similarly, where the basis of property in the hands of a corporation is a substituted basis, such basis, and not the fair market value of the property at the time of the acquisition by the corporation, is the basis for computing depletion and depreciation for the purpose of determining earnings and profits of the corporation.